



Security Council

Distr.: General
14 June 2006

Original: English

Letter dated 12 June 2006 from the Secretary-General addressed to the President of the Security Council

Pursuant to Security Council resolutions 1483 (2003) and 1637 (2005), I have the honour to convey a letter dated 7 June 2006, from my representative on the International Advisory and Monitoring Board for Iraq (see annex).

I should be grateful if you would bring this matter to the attention of the members of the Security Council.

(Signed) Kofi A. Annan



Annex

Letter dated 7 June 2006 from the representative of the Secretary-General on the International Advisory and Monitoring Board for the Development Fund for Iraq addressed to the Secretary-General

As your representative on the International Advisory and Monitoring Board (IAMB) for the Development Fund for Iraq (DFI), I am pleased to provide you with an update on the activities of the Board since my letter dated 7 February 2006 (see enclosure).

As I mentioned in my letter of 7 February 2006, I had made a request to the United States Special Inspector General for Iraq Reconstruction for a briefing on the results of his office's work related to the use of DFI funds. Representatives of IAMB had a useful meeting with the Special Inspector General for Iraq Reconstruction and his colleagues on 5 April 2006. We sought and obtained clarification of recent reports of the Special Inspector General related to the use of resources from DFI. The reported concerns of the Special Inspector General echo concerns consistently raised by IAMB and the DFI external auditors regarding the use of DFI resources. We will continue to share with the Special Inspector General issues of mutual concern, and this should be facilitated by the attendance of representatives of the Special Inspector General at meetings of IAMB.

IAMB met in Washington, D.C., on 30 and 31 May 2006. IAMB was briefed by Ernst & Young, the appointed DFI auditor, on the status of the audit of the resources and disbursements of DFI and of the oil export sales from 1 July 2005 to 31 December 2005. There has been slow progress to date. IAMB reiterated the need for timely completion.

IAMB received a briefing from the President of the Board of Supreme Audit of Iraq (BSA). He outlined the capacity-building initiative that BSA had embarked on and a summary of the main findings of recent audits that have a bearing on the work of IAMB and the financial position of DFI, including relevant audits in regard to the oil extraction and sales.

IAMB received a briefing from representatives of the United States Department of Defense regarding pending audits. In my letter of 7 February, I informed you that IAMB planned to request an independent verification of the settlement between the United States Government and Kellogg, Brown and Root (KBR) on 22 December 2005 regarding the work performed by KBR funded from DFI, as well as a review of the remaining sole-sourced contracts awarded by the Coalition Provisional Authority and funded from DFI. The representatives of the United States Department of Defense indicated that the follow-up audit of sole-sourced contracts has only recently been awarded. The audit of the remaining sole-sourced contracts is expected to be completed by September. With regard to the review of the KBR settlement, the United States Government is still in the process of identifying a suitable audit firm; the major internationally recognized auditing firms having declined to participate. Progress has been slow. IAMB has urged the expeditious completion of these special audits.

One of the main concerns of IAMB from the start has been the absence of metering for crude oil production. IAMB had recommended in 2004 the expeditious

installation of metering equipment in accordance with standard oil industry practices. The Government of Iraq informed IAMB in March that the Iraqi Ministry of Oil had concluded an agreement with the United States Government to rebuild the metering system in the Basrah oil port of the Southern Oil State Company, funded by a grant from the United States Government and expected to be completed by the end of 2006. In addition, a preliminary agreement has been entered into by the Government of Iraq with the Shell Oil Company to act as a consultant to the Iraqi Ministry of Oil in matters relating to metering and calibrating, which would include the establishment of a measuring system for the flow of oil, gas and related products within Iraq, and export and import operations, within the next two years. IAMB welcomed the action the Government of Iraq is taking on the implementation of the IAMB recommendations, but continued to reiterate its concern that key actions, especially the installation of an oil metering system, needed to be comprehensive and were taking a long time to implement.

The IAMB mandate will expire by 31 December 2006. IAMB believes that it is important to continue the oversight role over oil export sales, and the related resources. IAMB believes that an oversight body should be set up by the Government of Iraq that would be independent, competent and professional, to ensure the continued oversight of external audits. To assist in a smooth transition to an Iraqi oversight body, IAMB is in the process of formulating recommendations on the modalities of such an oversight body and will present them to the Government of Iraq.

The next meeting of IAMB will take place in July. IAMB expects to review at that meeting the audit of the resources and disbursements of DFI and of the oil export sales from 1 July 2005 to 31 December 2005.

All documentation, including press statements, the minutes of all IAMB meetings, the results of the audit reports and key documents related to the IAMB mandate and operations, will continue to be posted on the IAMB website (www.iamb.info).

(Signed) Jean-Pierre Halbwachs

Enclosure

Letter dated 7 February 2006 from the representative of the Secretary-General on the International Advisory and Monitoring Board for the Development Fund for Iraq addressed to the Secretary-General

As your representative on the International Advisory and Monitoring Board (IAMB) for the Development Fund for Iraq (DFI), I am pleased to provide you with an update on the activities of the Board since my letter dated 2 June 2005.

At its meeting in October 2005, IAMB received reports of the audit of DFI covering the period from 1 January 2005 to 30 June 2005 and a briefing by KPMG. The audits were conducted under the oversight of IAMB, in line with its terms of reference and the provisions of Security Council resolution 1483 (2003), and are available on the IAMB website (www.iamb.info).

IAMB noted that these audits of the accounting of DFI resources, oil export sales and the transfers to spending ministries continue to be critical of the overall financial control framework currently in place. The reports continue to highlight numerous exceptions to administrative and accounting procedures in the spending ministries and by the United States agencies in respect of outstanding commitments for which they have used DFI resources and use by the Iraqi administration of DFI resources.

IAMB was also informed that KPMG continued to face lack of cooperation among some ministries and required the intervention of the Ministry of Finance to conduct complete its work.

IAMB sought and received a briefing from representatives of the Government of Iraq on the implementation of the recommendations contained in the audits and on measures to address the shortcomings identified by IAMB and in the audit reports and to improve internal financial controls generally. The steps reported by the Government of Iraq are detailed below.

The Government of Iraq has enacted a Financial Management Law, which has established a comprehensive framework for the conduct of fiscal and budgetary policy in line with international best practices by setting a structured process for the formulation of the federal budget and a number of reporting requirements aimed at increasing the accountability and transparency of the budgeting process.

A department has been set up within the Board of Supreme Audit (BSA) to follow up on all audit and investigation reports, including those commissioned by IAMB.

A specialized directorate has been established within each ministry, headed by an Inspector General who reports directly to the Minister and whose duties are to audit and oversee public funds administered by the ministry.

The Constitution adopted specifies the organizations which will be responsible for the audit and oversight of public funds. These organizations are BSA and the Integrity Commission.

IAMB believes that it is extremely important for the Government of Iraq to act on the audit recommendations to strengthen financial controls and the

administration of DFI resources, and looks forward to working with BSA and the Government of Iraq to continue strengthening the overall framework for public and financial management in Iraq. IAMB welcomed the action the Government of Iraq is taking on the implementation of IAMB recommendations, but also reiterated its concern that key actions, especially the installation of an oil metering system, were taking a long time to implement. IAMB urged the Government of Iraq to implement all audit recommendations promptly.

With regard to DFI-funded contracts administered by United States agencies, IAMB was informed by representatives of the United States that the Finance Minister of Iraq signed on 24 December 2005 a memorandum extending the Designation of Authority and Responsibility to the United States Chief of Mission and Commander, Multinational Forces-Iraq, to continue to administer the DFI-funded contracts until 31 December 2006 in view of the small number of contracts remaining and the fact that those contracts would be completed by the end of 2006. IAMB was also informed that the Joint Contracting Command-Iraq continues to work on a handover of records to appropriate Iraqi ministries before the end of 2006.

In my previous letter, I had informed you that IAMB agreed to the terms of reference for a special audit of sole-sourced contracts using DFI funds proposed by the United States Government, to be completed by an independent auditor. The special audit of sole-sourced contracts called for (a) identifying all contracts awarded non-competitively by the Coalition Provisional Authority valued at over \$5 million that used DFI funds; (b) providing a summary of the findings of audits of such contracts that have already been conducted by various United States Government audit agencies, and (c) conducting additional audit procedures on non-competitively awarded contracts that have not been the subject of audit, including with regard to whether such contracts were in accordance with the purposes outlined in Security Council resolution 1483 (2003).

The United States Government had informed IAMB that KPMG LLP had been selected to undertake the special audit of sole-sourced contracts that were funded from DFI. The audit reports were scheduled for completion and transmission to IAMB by the end of August 2005.

In September 2005, the United States Government informed IAMB that KPMG had determined that a potential conflict of interest had arisen in respect of auditing the sole-sourced contract awarded to Kellogg, Brown and Root (KBR) due to the existing client relationship of KPMG with Halliburton, the parent company of KBR, and had recused itself from auditing the KBR contract. In the light of this, the United States Government informed IAMB that it had requested the assistance of the United States Special Inspector General for Iraq Reconstruction to perform the procedures of the special audit with respect to the sole-sourced contract awarded to KBR.

IAMB regretted that KPMG had recused itself from conducting the KBR part of the audit only after it had been awarded the audit contract. IAMB also regretted the fact that it was informed very late by the United States Government of the recusal of KPMG and the appointment of the Special Inspector General to conduct the audit of the sole-sourced contract relating to KBR, and that IAMB had not been consulted in this matter. This did not make it possible for IAMB to pursue alternatives within the available time frame.

Of the 24 contracts (value: \$1.963 billion) identified as sole-sourced, 23 (value: \$0.563 billion) were audited by KPMG and one (value: \$1.4 billion) was audited by the Special Inspector General. The KPMG audit revealed exceptions in a number of cases, including (a) insufficient documentation to justify non-competitive contracting; (b) lack of support for the provision of services or receipt of goods; and (c) discrepancies in the amounts billed. The report of the Special Inspector General revealed that "the non-competitive award of contract ... to Kellogg, Brown and Root was properly justified". The contract was a cost-plus-award-fee, indefinite-delivery, indefinite-quantity contract. Determination of fair and reasonable costs for such contracts, according to the Special Inspector General, was made upon "definitization" of each task order. Six task orders used DFI funds. One of the six task orders had been "definitized" and the costs were determined to be fair and reasonable. The remaining five task orders had not been "definitized" and the process to substantiate expenditures, amounting to \$208 million, which had been questioned by the United States Defense Contract Audit Agency (DCAA) was still ongoing. IAMB also noted key findings in the DCAA audit report stating that (a) the contractor's proposals as submitted were not acceptable for negotiation of a fair and reasonable price; (b) supporting data for subcontract costs were not always adequate; and (c) proposals were not prepared in all respects in accordance with applicable cost accounting standards and appropriate provisions of the United States Federal Acquisition Regulation.

IAMB was also informed that \$1.2 billion out of the \$1.4 billion earmarked for the KBR contract had already been disbursed from DFI. Given the amounts involved and the length of time that this process was taking, IAMB recommended that the United States Government seek resolution with the Iraqi Government concerning the use of resources of DFI which might be in contradiction of the Security Council resolution 1483 (2003) and that the amount disbursed to contractors that cannot be supported as fair be reimbursed expeditiously.

IAMB followed up on the results of the special audit of sole-sourced contracts, and in particular the KBR task orders funded from DFI. At its meeting in January 2006, IAMB was informed by representatives of the United States Government that a global settlement of all six DFI-funded task orders under the KBR contract was reached between the United States Government and KBR on 22 December 2005. The settlement provided for a reduction of contract costs of \$9 million. IAMB resolved to request an independent verification of the settlement as well as a review of the remaining sole-sourced contracts. IAMB is in the process of defining the scope of work for this task and will be pursuing this with representatives of the United States Government.

On 28 December 2005 IAMB held a press briefing on the work of IAMB and replied to questions raised by members of the press. The webcast of the briefing, as well as a transcript, is posted on the IAMB website (www.iamb.info).

The United States Special Inspector General for Iraq Reconstruction issued on 26 January 2006 an audit report relating to the administration of DFI funds by the Coalition Provisional Authority South-Central Region. That audit report discusses the processes used for the authorization, award, execution and oversight of contracts within the Coalition Provisional Authority South-Central Region.

The overall audit objective was to determine whether disbursing officers in selected locations in southern Iraq complied with applicable guidance and properly

controlled and accounted for DFI cash assets and expenditures. The report indicates that during the audit, the Special Inspector General observed deficiencies in contract-award documentation and expanded its scope to determine whether Coalition Provisional Authority South-Central Region personnel properly managed contracts.

The audit concluded, based on the documentation examined, that the Coalition Provisional Authority South-Central Region failed to adequately manage its Rapid Regional Response Program contracts and micro-purchases. IAMB has concluded that a briefing by the Special Inspector General on the results of the Special Inspector General's audits involving DFI funds would be desirable, and I have today made a request to the Special Inspector General for such a briefing.

The next meeting of IAMB is scheduled for May 2006. IAMB expects to receive by then the audit of DFI for the period from June to December 2005 and further reports on the implementation by the Government of Iraq on measures to address issues identified in the audit reports.

IAMB will continue to exercise its oversight role and plan for a smooth transition to an Iraqi oversight body.

All documentation, including press statements, the minutes of all IAMB meetings, the results of the audit reports and key documents related to the IAMB mandate and operations, will continue to be posted on the IAMB website (www.iamb.info).

(Signed) Jean-Pierre **Halbwachs**